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In The

Supreme Court of the United States

October Term, 1968

No. 970

ROBERT E. S. YOUNG,

Petitioner,

vs.

JOHN A. MADER, ERNEST W. WILSON, MAX O. MILLER, et. al.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

Petitioner prays that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Sixth Circuit, entered in the above entitled case on October 29, 1968.

CITATIONS TO OPINIONS BELOW

The order of the United States District Court for the Southern District of Ohio (Eastern Division) is unreported and is printed in Appendix B hereto, infra pp. 42-50. The opinion of the Circuit Court of Appeals, is reported at 402 F. 2d 158 and is printed in Appendix B hereto, infra pp. 34-42.

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* The Securities and Exchange Commission appeared as Amicus Curiae below in an adverse position to Petitioner.

JURISDICTION

The judgment of the Circuit Court of Appeals for the Sixth District was entered on October 29, 1968. The jurisdiction of this Court is invoked under 62 Stat. 928 (1948), 28 U.S.C. §1254(1) (1958).

THE QUESTIONS PRESENTED

I

Did not the Court of Appeals for the Sixth Circuit err in holding that the respondents, John A. Mader, Ernest W. Wilson and Max O. Miller, had a cause of action for damages under Section 10 (b) of the Securities Exchange Act of 1934 (48 Stat. 891 (1934), 15 U.S.C. §78j (1958)) and Rule 10-b-5 (17 C.F.R. §240, 10-b-5) adopted by the Securities and Exchange Commission?

II

Did not the Court of Appeals for the Sixth Circuit err in holding that Rule 10 b-5 (17 C.F.R. §240, 10-b-5) adopted by the Securities and Exchange Commission did not exceed the authority granted the Securities and Exchange Commission by Congress under Section 10 (b) of the Securities Exchange Act of 1934, (48 Stat. 891 (1934), 15 U.S.C. §78j (1958))?

III

Did not the Court of Appeals for the Sixth Circuit err in holding that the respondents, John A. Mader, Ernest W. Wilson and Max O. Miller, as representatives of a class in order to recover damages merely must prove a violation of Rule 10 b-5 (17 C.F.R. §240, 10-b-5) and that they were damaged as a result thereof?

IV

Did not the Court of Appeals for the Sixth Circuit err in holding that the exchange of stock in a statutory merger constituted a purchase or sale under Section 10 (b) of the Securities Exchange Act of 1934 (48 Stat. 891 (1934), 15 U.S.C. §78j (1958)) and under Rule 10 b-5 (17 C.F.R. §240, 10-b-5) adopted by the Securities and Exchange Commission?

V

Did not the Court of Appeals for the Sixth Circuit err in holding that installment subscribers to shares of a corporation merged with another corporation who continued to make payments to the second corporation after the merger, should be considered shareholders entitled to maintain an action under Section 10 (b) of the Securities Exchange Act of 1934 (48 Stat. 891 (1934), 15 U.S.C. §78j (1958)) and Rule 10 b-5 (17 C.F.R. §240, 10-b-5) adopted by the Securities and Exchange Commission?

STATUTE AND RULE INVOLVED

The statutory provision involved is Section 10 (b) of the Securities Exchange Act of 1934, (48 Stat. 891 (1934), 15 U.S.C. §78j (1958)).

The rule involved is Rule 10 b-5 (17 C.F.R. §240, 10 b-5) adopted by the Securities and Exchange Commission.

The statute and rule are printed in Appendix A, hereto, infra pp. 16-17.

STATEMENT

The respondents brought an action in the United States District Court for the Southern District of Ohio, Eastern Division, against petitioner and others as officers and directors of Certified Mortgage Company, (Mortgage) an Ohio corporation, which was merged into Certified Credit Corporation, (Credit) an Ohio corporation, on December 31, 1959. This merger was pursuant to Sections 1701.78 to 1701.81, inclusive, of the Ohio Revised Code. (The aforesaid statutory provisions are printed in Appendix A, hereto, infra pp. 17-33.) Respondents prior to December 31, 1959 were holders of Class A and Class B shares of Mortgage and certain respondents and others for which their action was instituted were subscribers to shares of Mortgage, or holders of options for additional shares of Mortgage; all of said subscriptions were obtained prior to November 28, 1959, the date the proxy statement was mailed by Mortgage to its shareholders. Respondents claimed the proxy statement was false, fraudulent, manipulative and deceptive. Respondents instituted said suit on behalf of themselves and all persons similarly situated to recover the value of their shares of stock alleged to have been destroyed by the merger under Section 10 (b) of the Securities Exchange Act of 1934 (48 Stat. 891 (1934), 15 U.S.C. §78j (1958)) and under Rule 10 b-5 (17 C.F.R. §240, 10 b-5)

adopted by the Securities and Exchange Commission. Answer filed by petitioner along with answers of other defendants, denied that he was an officer and director of Mortgage. Petitioner and other defendants each filed motions to dismiss and/or for summary judgment.

On April 24, 1967, the District Judge granted petitioner's motion to dismiss and for a summary judgment. The District Judge held that the merger of Mortgage into Credit, two Ohio corporations, under the statutes of the State of Ohio did not involve a sale of securities within the meaning of Section 10 (b) of the Securities Exchange Act of 1934, (48 Stat. 891 (1934), 15 U.S.C. §78j (1958)) and Rule 10 b-5 (17 C.F.R. §240, 10 b-5) adopted by the Securities and Exchange Commission. The District Judge further held that the action could not be maintained for the benefit of the shareholders as a class. The United States Court of Appeals for the Sixth Circuit held the opposite and reversed the judgment of the District Court and remanded the case.

REASONS FOR GRANTING THIS WRIT

The United States Court of Appeals for the Sixth Circuit by reversing the decision of the United States District Court for the Southern District of Ohio:

(1) has passed upon questions arising under the laws of the United States and a Regulation of the Securities and Exchange Commission which vitally affect private enterprise;

(2) has rendered a decision which is in conflict with decisions of other Courts of Appeals with respect to the requirement of reliance as an essential element of a cause of action under Rule 10 b-5 of the Securities and Exchange Commission;

(3) has committed error in holding that an acquisition of stock pursuant to operation of law (an Ohio statutory merger) is a purchase or sale of a security under Rule 10 b-5 of the Securities and Exchange Commission; and in holding that persons who subscribed to stock of the merging corporation prior to the offensive proxy solicitation, and were issued shares of the surviving corporation, were purchasers or sellers under Rule 10 b-5;

(4) has proliferated the law so as to distort congressional intent and cast the law into a state of chaos so as to command the exercise of this Court's power of supervision.

ARGUMENT

Question No. I

Did not the Court of Appeals for the Sixth Circuit err in holding that the respondents, John A. Mader, Ernest W. Wilson and Max O. Miller, had a cause of action for damages under Section 10 (b) of the Securities Exchange Act of 1934 (48 Stat. 891 (1934), 15 U.S.C. §78j (1958)) and Rule 10b-5 (17 C.F.R. §240, 10-b-5) adopted by the Securities and Exchange Commission?

This Court has never decided the basic question of whether or not Rule 10 b-5 of the Securities and Exchange Commission confers a right of recovery by implication and secondly if the Rule implies that right, upon what legal principle does that right rest.

The first judicial pronouncement on the availability of a civil remedy for violation of Rule 10 b-5 was in *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa 1946). The court adopted the statutory tort theory and assumed that the legislative intent was to grant recovery by reason of the failure of Congress to expressly, clearly and plainly deny the recovery.

From *Kardon* (cited supra) there began a procession of cases utilizing Rule 10 b-5 which, at the present time, according to Alan B. Bromberg, who has devoted an entire book to the subject of Rule 10 b-5, *Securities Law-Fraud S. E. C. Rule 10 b-5* (1968—McGraw-Hill Book Co., 702 pp.), represents about one-third of all current cases, public and private, under all Securities statutes, and produce almost as much litigation as all other general anti-fraud provisions, and several times as much as the express liabilities.

The incidence of the utilization of Rule 10 b-5 has reached a point of serious concern to the great body of citizens who participate, actively or inactively, in the management of private corporations.

The Statistical Abstract of the United States, published by the United States Department of Commerce, 89th Ed., 1968 at page 388 reveals that 1,526,000 corporations filed income tax returns in 1967; this represents an increase of 106,000 over the number filing in 1965. All but a few states require at least three directors which means that 4,578,000 citizens are thereby directly affected by Rule 10 b-5. The list of additional potential defendants under Rule 10 b-5 as now interpreted by the lower courts would include:

1. those in positions of management;
2. those giving legal advice (attorneys) to these corporations;
3. those giving fiscal advice (accountants);
4. those directly involved with transfers of stock (brokers and underwriters).

It is thus apparent that a large segment of the citizenry is affected by this Rule. Not one state in this Union of States is without potential defendants, under this Rule.

The corporate form of organization is increasing in its popularity as a tool of private enterprise. The Statistical

Abstract of the United States (cited supra) states that corporation stock represents 778 billions of dollars in 1965, i.e. 27.5% of the total financial assets as compared to 15.6% in 1945 and corporation stock represented 33.3% of the total national wealth in 1965 as compared to 20.5% in 1945.

Question No. II

Did not the Court of Appeals for the Sixth Circuit err in holding that Rule 10 b-5 (17 C.F.R. §240, 10-b-5) adopted by the Securities and Exchange Commission did not exceed the authority granted the Securities and Exchange Commission by Congress under Section 10 (b) of the Securities Exchange Act of 1934 (48 Stat. 891 (1934), 15 U.S.C. §78j (1958))?

In *Birnbaum v. Newport Steel Corporation,* 193 F. 2d 461 (2nd C. A. 1952) certiorari denied, 343 U.S. 956 (1952) the court noted that Section 10 (b) of the Securities Exchange Act does not by its terms make unlawful any conduct or activity but confers rule making power upon the Commission to condemn deceptive practices in the sale or purchase of securities. This distinction has apparently gone unnoticed by the courts. It is submitted that this distinction is important and must be considered in the light of the various judicial theories (statutory tort, statutory implication, statutory voidability, and statutory policy) which have been applied by the various courts to sustain implied liability.

Much has been written by those learned in the nuances of civil liabilities under the Securities Exchange Act of 1934. The legal Bibliography on the Securities Exchange Act of 1934 by Chester Dunton, Librarian of the Securities and Exchange Commission, notes 501 articles in law review journals and other periodicals from 1934 to 1963.

David S. Ruder, Assistant Professor of Law, Northwestern University, presents an exhaustive documentation for the proposition that Congress did not intend to create an implied right of action for civil recovery for violation of a Rule promulgated by the Securities Exchange Commission in "Civil Liability under Rule 10 b-5—Judicial Revision of Legislative Intent", 57 Nw. U. L. Rev. 627-690 (1963) and "Pitfalls in the Development of a Federal Law of Corporations by Implication through Rule 10 b-5", 59 Nw. U. L. Rev. 185 (1964). See also Proceedings, Conference on Codification of Federal Securities Law, 22 The Business Lawyer 793, 922 (1967) wherein Milton Freeman, a Commission staff member who participated in the drafting of Rule 10 b-5, stated:

> "It [Rule 10 b-5] was intended to give the Commission the power to deal with this problem. It had no relation in the Commission's contemplation to private proceedings." [supplied by writer]

The release promulgating the Rule also confirms the Commission's intention *not* to create civil liability:

> "The new Rule *closes a loophole in protection against fraud administered by the Commission* by prohibiting individuals or companies from purchasing securities if they engage in fraud in their purchase." (Emphasis added). S.E.C. Release No. 3230 (1942).

Question No. III

Did not the Court of Appeals for the Sixth Circuit err in holding that the respondents, John A. Mader, Ernest W. Wilson and Max O. Miller, as representatives of a class in order to recover damages merely must prove a violation of Rule 10 b-5 (17 C.F.R. §240, 10-b-5) and that they were damaged as a result thereof?

The court's holding that respondents' action is a proper class action under Rule 23 of the Federal Rules of Civil

Procedure, arrived at by reason of its holding that reliance is not a necessary element of a cause of action under Rule 10 b-5, conflicts with the decision of 2nd Circuit Court of Appeals in *S. E. C. v. Texas Gulf Sulphur Company,* 401 F. 2d 833 (1968) wherein the court stated at page 860:

> ". . . Congress when it used the phrase 'in connection with a purchase or sale of any security' intended only that the device employed, whatever it might be, be a sort that would cause reasonable investors to rely thereon, and, in connection therewith, *so relying,* cause them to purchase or sell a corporation's securities." (Emphasis added)

In the *Texas Gulf Sulphur* case (cited supra, at page 849) the court approved its earlier holding in *List v. Fashion Park, Inc.* 340 F. 2d 457 (1965) which was a case between private litigants. In *List* the court had the question of materiality of nondisclosed facts and the question of reliance thereon and at pages 462 and 463 stated:

> "Disagreement centers on the applicability and meaning of the requirements that reliance be placed upon the misrepresentation. *Our examination of the authorities satisfies us that this requirement also is carried over into civil suits under Rule 10 b-5. Reed v. Riddle Airlines,* 266 F. 2d 314, 319 (5 Cir. 1959); *Kohler v. Kohler Co.,* 208 F. Supp. 808, 823 (E.D.Wis. 1962), *aff'd* 319 F. 2d 634 (7 Cir. 1963); *Mills v. Sarjem Corp.,* 133 F. Supp. 753, 767 (D.N.J. 1955); *Speed v. Transamerica Corp.,* 5 F.R.D. 56, 60 (D.Del. 1945); *accord,* Loss, Securities Regulation 1765-66. *The dicta* in *Kardon v. National Gypsum Co.,* 83 F. Supp. 613, 614 (E.D. Pa. 1947), are not necessarily to the contrary . . . This interpretation of Rule 10 b-5 is a reasonable one, for the aim of the rule in cases such as this is to qualify, as between insiders and outsiders, the doctrine of *caveat emptor*—not to establish a scheme of investors' insurance. Assuredly, to abandon the requirement of reliance would be to facilitate outsiders' proof

> of insiders' fraud, and to that extent the interpretation for which plaintiff contends might advance the purposes of Rule 10 b-5. But this strikes us as an inadequate reason for reading out of the rule so basic an element of tort law as the principle of causation in fact. Plaintiff's citation of decisions by the Securities and Exchange Commission, and commentary thereon, does not persuade us otherwise. *Cady, Roberts & Co.*, Sec. Ex. Act Rel. 6668, p. 9 (1961); III Loss, Securities Regulations 1438-39 n. 30. The aim of administrative proceedings under Rule 10 b-5 is to deter misconduct by insiders, rather than to compensate their victims." (Emphasis added)

The court concluded at page 463 that the test of reliance upon an undisclosed fact was:

> ". . . whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact. *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 829 [appr. in prin., 235 F. 2d 369 (3 C.A. 1956)]; *Kardon v. National Gypsum Co.*, 73 F. Supp. 798, 800 (E.D. Pa. 1947). To put the matter conversely, insiders 'are not required to search out details that presumably would not influence the person's judgment with whom they are dealing.' *Kohler v. Kohler Co., supra*, 319 F. 2d at 642. This test preserves the common law parallel between 'reliance' and 'materiality,' differing as it does from the definition of 'materiality' under Rule 10 b-5 solely by substituting the individual plaintiff for the reasonable man." [supplied by writer]

The Sixth Circuit Court's ruling that the action is proper as a class action ignores both the requirement of materiality of nondisclosed facts and the requirement of reliance and is thus in conflict with decisions of the 2nd, 3rd and 7th Circuit Courts of Appeals.

While it may be true that "investors" are to be accorded all means of protection it is submitted that this

"insurance protection" should not be extended by the courts to the point of depriving a defendant of his right to have a case made out against him under a definite and uniformly applied theory of law. The elimination by the lower court of all but two of the five common law elements of fraud is most certainly a broadening of the Securities Exchange Act in ways not intended by Congress. (*Blau v. Lehman,* 368 U.S. 403 (1962)

Question No. IV

Did not the Court of Appeals for the Sixth Circuit err in holding that the exchange of stock in a statutory merger constituted a purchase or sale under Section 10 (b) of the Securities Exchange Act of 1934 (48 Stat. 891 (1934), 15 U.S.C. §78j (1958)) and under rule 10 b-5 (17 C.F.R. §240, 10-b-5) adopted by the Securities and Exchange Commission?

The arguments appearing under Questions I and II are equally applicable to this question.

The lower court has extended the "constructive sale" or "involuntary seller" theory of *Vine v. Beneficial Finance Company,* 373 F. 2d 627 (2nd Cir. 1967) so that one who acquires a security solely by operation of a state law is a purchaser or a seller under Rule 10 b-5. (See Ohio current merger statutes, Appendix A, infra pp. 17-33). If this precedent stands together with the previous decisions of other courts, the last vestige of the purchaser-seller requirement will have disappeared and the security holder will be completely absolved from any responsibility to make any inquiry beyond that which appears on the face of the proxy solicitation—the investor will be completely and fully insured at the sole expense of management. In the instant case the alleged offensive solicitation for proxies included the following *Caveat*:

"The discussion herein reflects the opinion of management and is not a substitute for the information available by reading the proposal as a whole . . ."

The potential scope of liability if all mergers, *ipso facto,* are included within Rule 10 b-5, has not been estimated. It has, however, been reported that there are over $77 million dollars involved in potential private actions as a result of the 2nd Circuit Court's decision in *S. E. C. v. Texas Gulf Sulphur Company*, 401 F. 2d 833 (1968) (See 24 The Business Lawyer, p. 55)

Question No. V

Did not the Court of Appeals for the Sixth Circuit err in holding that installment subscribers to shares of a corporation merged with another corporation who continued to make payments to the second corporation after the merger, should be considered shareholders entitled to maintain an action under Section 10 (b) of the Securities Exchange Act of 1934 (48 Stat. 891 (1934), 15 U.S.C. §78j (1958)), and Rule 10-b-5 (17 C.F.R. §240, 10-b-5) adopted by the Securities and Exchange Commission?

Under Ohio law a subscriber for shares is a shareholder (Section 1701.01 (F) of the Ohio Revised Code, see Appendix A, pp. 16, 17) and shares are deemed outstanding *when they are subscribed for even though the certificate may not be issued until fully paid.* (12 Ohio Jurisprudence, 2d., 191) By its holding that installment subscribers were shareholders entitled to maintain an action under Rule 10 b-5 by alleging offensive proxy solicitations, the court has completely obviated the plain meaning of Section 10 (b) of the Securities Exchange Act of 1934 (48 Stat. 891 (1934), 15 U.S.C. §78j (1958)), that the alleged violation be "*in connection with* the purchase or sale of any security". The question of when a person becomes a shareholder must be

determined under the law of the state of incorporation, and once that legal relationship is fixed how can an alleged offensive proxy solicitation, not yet in existence, have been used in connection with that sale?

CONCLUSION

Chief Justice Fred M. Vinson in an address to the American Bar Association in 1949 (69 S. Ct. v, vi) said that to remain effective, the Supreme Court must continue to decide only those cases which present questions whose resolution will have immediate importance far beyond the particular facts and parties involved. The case before the Court is such a case.

In the November 1968 issue of The Business Lawyer, Vol. 24, pp. 69-76, in an article titled "What Lies Ahead Under Rule 10 b-5," the author, Harold Marsh, Jr., Professor of Law, University of California, concludes in answer to that question "More Chaos". In an article in N.Y.U.L. Rev., Vol. 43: 541-564, at page 542 it is stated:

> ". . . the private right of action will serve such a deterrent function only if potential violators of the rule — those who, because of their occupations or avocations are involved with securities transactions or corporate affairs — know that it is possible for them to conduct themselves so as not to run afoul of the law. *Yet under existing case law it is difficult, if not impossible to find any ascertainable guidelines for the avoidance of civil liability.*" (Emphasis added)

In the May-June issue, 1967, of the Northwestern University Law Review, Vol. 62, No. 2 (pp. 181-205) Samuel W. Block, in discussing current critical points in stockholders litigation, concluded at page 205 as follows:

> "The need for guideposts in the shareholders litigation field is particularly acute as the exposure to liability increases and numerous factors previously reliable

> as restraints upon shareholders claims, are being swept aside by the high tide of judicial sympathy with investor protection."

The shifting emphasis from tangible to intangible property in this country and the need for greater participation by private enterprise in our economy are compelling reasons for this Court to grant the writ prayed for and to strive with the help of those learned in the specialized field of securities regulation to bring some order out of this chaos and guide the lower courts in their interpretation and application of Rule 10 b-5.

For the foregoing reasons, this petition for a Writ of Certiorari should be granted.

Respectfully submitted,

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Date: January 21, 1969

APPENDIX A

Section 10 (b) of the Securities Exchange Act of 1934, (48 Stat. 891 (1934), 15 U.S.C. §78j (1958)) provides in pertinent part as follows:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails or of any facility of any national securities exchange —
>
> • • •
>
> "(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10 b-5 (17 C.F.R. §240, 10-b-5) adopted by the Securities and Exchange Commission provides:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange —
>
> "(a) to employ any device, scheme or artifice to defraud,
>
> "(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> "(c) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person,
>
> "in connection with the purchase or sale of any security."

Ohio Revised Code:

> "Section 1701.01 As used in sections 1701.01 to 1701.98, inclusive, of the Revised Code, unless the context otherwise requires:

• • •

(F) 'Shareholder' means a person whose name appears on the books of the corporation as the owner of shares of such corporation. Unless the articles, the regulations, or the contract of subscription otherwise provides, 'shareholder' includes a subscriber to shares, whether the subscription is received by the incorporators or pursuant to authorization by the directors, and such shares shall be deemed to be outstanding shares;"

• • •

"Section 1701.78 (A) Any two or more corporations may merge into a single corporation which shall be one of the constituent corporations, or may consolidate into a single corporation which shall be a new corporation to be formed by the consolidation.

(B) To effect such merger or consolidation, the directors of each constituent corporation shall approve an agreement of merger or consolidation to be signed by the president or a vice-president and by the secretary or an assistant secretary of such corporation, which agreement shall set forth:

(1) That the named constituent corporations have agreed to merge into a specified constituent corporation, hereinafter designated the surviving corporation, or that the named constituent corporations have agreed to consolidate into a new corporation to be formed by the consolidation, hereinafter designated the new corporation;

(2) The name of the surviving or new corporation, which may be the same as or similar to that of any constituent corporation;

(3) The place in this state where the principal office of the surviving or new corporation is to be located;

(4) The purpose or purposes of the surviving or new corporation;

(5) The authorized number and the par value per share of shares with par value and the authorized number of

shares without par value of the surviving or new corporation (except that the agreement of merger or consolidation of a banking, safe deposit, trust, or insurance corporation shall not authorize shares without par value); the express terms, if any, of the shares; and, if the shares are to be classified, the designation of each class, the authorized number and par value per share, if any, of the shares of each class, and the express terms of the shares of each class;

(6) The amount, or the method of determining the amount, of stated capital of each class of shares to be outstanding at the time the merger or consolidation becomes effective, but the aggregate of the amounts of stated capital of all classes shall not be less than five hundred dollars, and the stated capital of each share with par value to be outstanding shall not be less than the par value of such share;

(7) The amount of the earned surplus of the surviving or new corporation, or the method of determining such amount, which amount shall not exceed the lesser of (a) the excess, if any, of the assets of the surviving or new corporation, taken at their fair value to the surviving or new corporation, over the sum of its liabilities, including liabilities derived from the constituent corporations or resulting from the merger or consolidation, and stated capital, and (b) the combined earned surplus of the constituent corporations diminished by the deficit of any constituent corporation;

(8) The names and addresses of the first directors and officers of the surviving or new corporations, and if desired, their term or terms of office;

(9) The name and address of the statutory agent upon whom any process, notice, or demand against any constitu-

ent corporation or the surviving or new corporation may be served;

(10) The terms of the merger or consolidation, the mode of carrying the same into effect, and the manner and basis of making distribution to shareholders of the constituent corporations, which distribution to shareholders of any of the constituent corporations, in extinguishment of or in substitution for shares of such constituent corporations, may be by way of shares of any class or classes of the surviving or new corporation, or of property other than such shares (including, but not limited to cash, notes, bonds, other evidences of indebtedness, or other property), or partly of such shares and partly of such other property, or which may consist of any combination thereof; provided that, after giving effect to such distribution, there shall be reserved an amount of assets which, taken at their fair value to the surviving or new corporation, is not less than the sum of the liabilities of the surviving or new corporation, including those derived by it from the constituent corporations, and the amounts of stated capital and surplus specified in the agreement; and provided that no such distribution shall be effected if, when the merger or consolidation becomes effective, the surviving or new corporation is insolvent or there is reasonable ground to believe that, by such distribution, it would be rendered insolvent;

(11) The regulations of the surviving or new corporation or a provision to the effect that the regulations of one of the constituent corporations shall be the regulations of the surviving or new corporation or to the effect that the shareholders or the directors of the surviving or new corporation may adopt regulations, or any combination thereof.

(C) The agreement may also set forth:

(1) A statement of, or a statement of the method of determining, the fair value of the assets to be owned by the surviving or new corporation;

(2) A statement that all or any portion of the amount representing an excess of the assets of such surviving or new corporation, taken at their fair value to the surviving or new corporation, over the aggregate of its liabilities, including those derived by it from the constituent corporations, plus stated capital, shall constitute capital surplus of the surviving or new corporation;

(3) The specification of a date, which may be the date of the filing of the agreement or a date subsequent thereto, upon which the merger or consolidation shall become effective;

(4) A provision conferring upon the directors of one or more of the constituent corporations the power to abandon the merger or consolidation prior to the filing of the agreement;

(5) Any additional provision permitted to be included in the articles of a newly formed corporation;

(6) Any additional provision deemed necessary or desirable with respect to the proposed merger or consolidation.

Section 1701.79 (A) The directors of each constituent corporation, upon approving the agreement of merger or consolidation, shall direct that the agreement be submitted to the shareholders entitled to vote on it at a meeting of shareholders of such corporation held for such purpose, and notice of such meeting shall be given to all shareholders of such corporation whether or not entitled to vote thereat, which notice shall be accompanied by a copy or summary of the agreement; provided, that an agreement of merger

need not be submitted to or adopted by the shareholders of the constituent corporation which is designated in the agreement of merger as the surviving corporation if all of the following conditions exist:

(1) There is no provision in the articles or the regulations of the corporation which is to survive which requires that the agreement of merger must be adopted by the shareholders of that corporation.

(2) The merger involves the issuance or transfer by the surviving corporation to the shareholders of the other constituent corporation or corporations of such number of shares of the surviving corporation as shall entitle the holders thereof to exercise less than one-sixth of the voting power of such corporation in the election of directors immediately after the consummation of the merger.

(3) The agreement of merger sets forth without change all of the provisions contained in the articles of the corporation which is to survive other than the statement with respect to initial stated capital.

(4) The agreement of merger adopts without change the regulations of the corporation which is to survive.

(5) The agreement of merger does not contain any provision conflicting with or effecting a change in any provision of the articles or the regulations of the corporation which is to survive.

(6) The agreement of merger sets forth as the first directors of the surviving corporation only those persons holding office as directors of the corporation which is to survive at the time of the adoption of the agreement of merger;

(7) The agreement of merger does not authorize or effect any particular corporate action which, under any applicable provision of law or the articles or the regulations

of the corporation which is to survive, could be authorized only by or pursuant to a vote of the shareholders of that corporation.

(B) At each such meeting, a vote of the shareholders shall be taken on the proposed agreement. In order to be adopted, the agreement including any amendments or additions thereto proposed at each such meeting must receive the affirmative vote of the holders of shares of such constituent corporation entitling them to exercise two-thirds of the voting power of such constituent corporation on such proposal, or, if the articles provide or permit, the affirmative vote of a greater or lesser proportion, but not less than a majority, of such voting power, and such affirmative vote of the holders of shares of any particular class as is required by the articles of such constituent corporation. In addition, whenever the agreement, if adopted, would have an effect which, if accomplished through an amendment to the articles, would entitle the holders of shares of any particular class to vote as a class on the adoption of such amendment, such agreement including any amendments or additions thereto proposed at each such meeting in order to be adopted must receive the affirmative vote of the holders of at least two-thirds or, if the articles provide or permit, a greater or lesser proportion, but not less than a majority, of the shares of such class. If the agreement would authorize any particular corporate action which, under any applicable provision of law or the articles of a constituent corporation, could be authorized only by or pursuant to a specified vote of shareholders, such agreement including any amendments or additions thereto proposed at each such meeting in order to be adopted must receive the affirmative vote so specified.

(C) At any time prior to the filing of the agreement, the merger or consolidation may be abandoned by the direc-

tors of one or more of the constituent corporations, if such power of abandonment is conferred upon such directors either by the agreement or by the same vote of shareholders of each of the constituent corporations as is required by division (B) of this section at the same meeting at which the agreement is adopted or at any subsequent meeting.

(D) If no adoption of the agreement by the shareholders of a constituent corporation is required by division (A) of this section, the approval of the agreement by the directors of such constituent corporation shall constitute adoption.

Section 1701.80 (A) Upon such adoption, a certificate, signed by the president or a vice-president and by the secretary or an assistant secretary of each constituent corporation and containing either a signed agreement or a copy thereof and a statement by such officers of each constituent corporation of the manner of its adoption by such corporation, shall be filed in the office of the secretary of state.

(B) Upon such filing or at such later date as the agreement specifies, the merger or consolidation shall become effective.

(C) A copy of such agreement, certified by the secretary of state, may be filed for record in the office of the county recorder of any county in this state, and for such recording the county recorder shall charge and collect the same fee as in the case of deeds. Such copy shall be recorded in the records of deeds.

Section 1701.81 (A) When such merger or consolidation becomes effective:

(1) The separate existence of all the constituent corporations, except the surviving or new corporation, shall cease, except that, whenever a conveyance, assignment, transfer, deed, or other instrument, or act, is necessary to vest property or rights in the surviving or new corpora-

tion, the officers of the respective constituent corporations shall execute, acknowledge, and deliver such instruments, and do such acts, and for such purposes the existence of the constituent corporations and the authority of their respective officers and directors shall be deemed continued notwithstanding the merger or consolidation.

(2) The constituent corporations shall become a single corporation which, in the case of a merger, shall be that one of the constituent corporations designated in the agreement of merger as the surviving corporation and, in the case of a consolidation, shall be the new corporation provived for in the agreement of consolidation.

(3) The surviving or new corporation shall have all the rights, privileges, immunities, powers, franchises, and authority and shall be subject to all the obligations of a corporation formed under sections 1701.01 to 1701.98, inclusive, of the Revised Code.

(4) The surviving or new corporation shall thereupon and thereafter possess all the rights, privileges, immunities, powers, franchises, and authority, as well of a public as of a private nature, of each of the constituent corporations; and all property of every description, and every interest therein, and all obligations, including subscriptions to shares, of or belonging to or due to each of the constituent corporations, shall thereafter be taken and deemed to be transferred to and vested in the surviving or new corporation without further act or deed; and title to any real estate, or any interest therein, vested in any of the constituent corporations shall not revert or in any way be impaired by reason of such merger or consolidation.

(5) To the extent permitted by the laws of any other state in which any constituent corporation has property, paragraph (4) of division (A) of this section applies in such state.

(6) The surviving or new corporation shall thenceforth be liable for all the obligations of each of the constituent corporations, including liability to dissenting shareholders; and any claim existing or action or proceeding pending by or against any of the constituent corporations may be prosecuted to judgment, with right of appeal as in other cases, as if such merger or consolidation had not taken place, or the surviving or new corporation may be substituted in its place.

(7) All the rights of creditors of each constituent corporation shall be preserved unimpaired, and all liens upon the property of any of the constituent corporations shall be preserved unimpaired, limited in lien to the property affected by such liens immediately prior to the effective date of the merger or consolidation.

(8) The agreement shall operate as amended articles in the case of a merger and as original articles in the case of consolidation.

(9) The assets owned by the surviving or new corporation shall be deemed to have a fair value to such corporation as stated in or as determined by a method stated in the agreement or, in the absence of a statement of such value or method, the agreement shall be deemed to have stated a fair value equal to the value as shown on the books of the constituent corporations at the time of the merger or consolidation.

(10) The excess, if any, of the assets owned by the surviving or new corporation, taken at their fair value to the surviving or new corporation, over the sum of its liabilities, including liabilities derived from the constituent corporations or resulting from the merger or consolidation, and stated capital, shall constitute earned surplus of the surviving or new corporation to the extent stated in or determined under a method stated in the agreement, and the

balance, if any, of such excess shall constitute capital surplus of such corporation.

(B) Dissenting holders of shares of a constituent corporation entitled by division (A) of section 1701.79 of the Revised Code to a notice of a meeting at which a vote is taken on the agreement whether or not entitled to vote thereat, are entitled to relief under section 1701.85 of the Revised Code if (1) such constituent corporation is being merged into another constituent corporation or is being consolidated into a new corporation, (2) the shareholders of the other constituent corporation or corporations would, when the merger becomes effective, own shares of the surviving corporation entitling them to exercise one-sixth or more of the voting power in the election of directors of the surviving corporation, or (3) the agreement would effect, as to such constituent corporation, the change or the provision specified in division (C) of section 1701.74 of the Revised Code; and dissenting holders of shares of a particular class of a constituent corporation entitled by division (A) of section 1701.79 of the Revised Code to notice of a meeting at which a vote is taken on the agreement are, whether or not entitled to vote thereat, entitled to relief under section 1701.85 of the Revised Code if the agreement would effect, as to such shares, one or more of the changes specified in division (A) or (B) of section 1701.74 of the Revised Code.

Section 1701.831 (A) Unless otherwise provided in the articles or the regulations, no approval by shareholders of the surviving domestic corporation shall be required for a merger into it of one or more corporations, domestic or foreign, all of whose outstanding shares are owned by such surviving domestic corporation, if the agreement of merger does not provide for any changes in the articles or regulations of, or the issuance of any shares by, the surviving

corporation. The agreement for a merger effected under this section shall set forth only the following:

(1) That the named constituent corporations have agreed to merge into the surviving domestic corporation;

(2) A statement of compliance with the conditions of this section and a statement that no approval by shareholders of the surviving domestic corporation is required;

(3) The terms of the merger and the manner of carrying the same into effect, which terms and which manner shall be in conformity with the provisions of this section;

(4) A statement of the amount, or the method of determining the amount, of the earned surplus of the constituent corporations which shall constitute earned surplus of the surviving corporation;

(5) If desired, the specification of a date, which may be the date of the filing of the agreement or a date subsequent thereto, upon which the merger shall become effective;

(6) Any additional provision deemed necessary or desirable with respect to the proposed merger, which provision shall be in conformity with the provisions of this section.

(B) When such merger becomes effective, the effect thereof shall be the same as in the case of the merger of domestic corporations or of domestic and foreign corporations otherwise than under this section, except that:

(1) The articles of the surviving domestic corporation in effect immediately prior to the merger shall continue to be the articles of the surviving domestic corporation;

(2) The regulations of the surviving domestic corporation in effect immediately prior to the merger shall continue to be the regulations of the surviving domestic corporation;

(3) Shareholders of the surviving corporation shall not be entitled to relief under section 1701.85 of the Revised Code.

Section 1701.85 (A) A shareholder entitled to notice of a meeting called to act upon any of the proposals mentioned in this section whose shares have not been voted, and shall not be voted, in favor of such proposal and whose shares are of a class or classes as to which relief under this section is granted by sections 1701.74, 1701.76, 1701.81, 1701.83, or 1701.84 of the Revised Code, when the articles have been amended, when all or substantially all the assets of the corporation have been authorized to be leased, sold, exchanged, transferred, or otherwise disposed of, when a merger or consolidation has been authorized, or when a combination or majority share acquisition has been authorized, shall be entitled, upon complying with the provisions of this section, to be paid the fair cash value of such shares held of record by him on the date for the determination of shareholders entitled to notice of said meeting. Such shareholder, in order to become entitled to such payment, shall serve a written demand therefor upon the corporation on or before the later of the two following dates:

(1) The thirtieth day after the giving of notice of the meeting;

(2) The tenth day after the taking of the vote adopting the amendment or authorizing the transaction.

The shareholder shall specify in said demand his name and address, the number and class of shares so held by him on said record date and with respect to which such demand is made, and the amount per share claimed by him as constituting such value. If the corporation mails a request therefor to the shareholder at the address specified in said demand, the shareholder, within fifteen days from the mailing of such request, shall deliver in accordance with said request the certificates representing such shares, in order that the corporation may indorse thereon a legend

to the effect that demand for the fair cash value of such shares has been made, whereupon the corporation shall promptly return such certificates, so indorsed, to the shareholder. If the corporation is unwilling to pay the amount so demanded, it may, within ten days after the expiration of the period within which such demands may be made, so notify the shareholder and make a counter-offer of a different amount per share as the fair cash value of the shares as to which demand has been made in compliance herewith. Either the demand of the shareholder or the counter-offer of the corporation, or both, may expressly provide that the same is made or given upon the condition that the amendment to the articles becomes effective or that the authorized transaction be consummated, as the case may be.

(B) The fair cash value of the shares involved in the demand by the shareholder shall be deemed to be the amount demanded by him if he has complied with the provisions of this section, or, if the corporation as aforesaid has made a counter-offer of a different amount per share, than the amount per share specified in such counter-offer, unless either:

(1) The corporation and the shareholder at any time within three months from the time said vote was taken agree upon a different amount;

(2) The shareholder or the corporation, within said three months(') period (but not thereafter), files a petition in the court of common pleas of the county in which the principal office of the corporation is located to determine the fair cash value per share.

Two or more dissenting shareholders may join as plaintiffs or may be joined as defendants in any such proceeding and any two or more such proceedings may be consoli-

dated. The petition shall contain a brief statement of the facts, including the vote and action objected to and the facts entitling the dissenting shareholder to the relief demanded. No answer to such petition shall be required. Upon the filing of the petition, the court, on the motion of the petitioner, shall enter an order fixing a date for hearing the petition, and requiring that a copy of the petition and a notice of the filing and of the date for hearing be given to the respondent or defendant in the manner in which summons is required to be served or substituted service is required to be made in other cases. On the day fixed for the hearing of the petition or any adjournment thereof, the court shall determine from the petition and from such evidence as is submitted by either party whether the shareholder is entitled to be paid the fair cash value of any shares and, if so, the number and class of such shares. Neither the making of a counter-offer by the corporation nor the request by the corporation that the shareholder deliver his share certificates for the indorsement of a legend thereon, nor the indorsement of such legend, shall be deemed to be an admission by the corporation that the shareholder is entitled to be paid the fair cash value of his shares. If the court finds that such shareholder is so entitled, it shall appoint three appraisers to determine such value of said shares and shall instruct the appraisers respecting their duties. The appraisers shall forthwith proceed to determine said fair cash value, and the appraisers, or a majority of them, shall make a report thereof within ten days, unless the court extends the time, and shall file their report with the clerk of the court, whereupon, on motion of either party, the report shall be submitted to the court and considered on such evidence as the court considers relevant; and if the fair cash value

set forth in the report is found reasonable, and is confirmed and approved by the court, judgment shall be rendered against the corporation for the payment of the amount of such fair cash value, with interest at such rate and from such date as the court fixes in said judgment. If the appraisers, or a majority of them, fail to file their report within ten days, or within such further time as is fixed by the court, or if the report is not confirmed by the court, the court shall summarily determine the fair cash value of the shares and render judgment therefor with interest thereon as aforesaid. The cost of the proceeding, including reasonable compensation to the appraisers to be fixed by the court, shall be assessed or apportioned as the court considers equitable. Such a proceeding shall be a special proceeding within the meaning of section 2505.02 of the Revised Code, and final orders therein may be vacated, modified, or reversed as provided in sections 2505.01 to 2505.45, inclusive, of the Revised Code. If during the pendency of any proceeding instituted under this section an action is or has been instituted to enjoin or otherwise to prevent such amendment or the carrying out of such transaction, the proceeding shall be stayed until the final determination of such action. Unless the provisions in division (D) of this section are applicable, the fair cash value of said shares, however, fixed, shall be paid within thirty days after the later of:

(1) The date of final determination of such value under this division (B);

(2) The effective date of the amendment to the articles or the consummation of the authorized transaction, as the case may be.

Such payment shall be made only upon and simultaneously with the surrender to the corporation of the certifi-

cates representing the shares for which such payment is made.

(C) The fair cash value of a share is hereby defined as the amount which a willing seller, under no compulsion to sell, would be willing to accept and a willing buyer, under no compulsion to purchase, would be willing to pay and shall be fixed as of the day prior to that on which said vote was taken, provided that in no event shall the amount thereof exceed that specified in the demand of the particular shareholder. There shall be excluded from such value any appreciation or depreciation resulting from the proposal acted upon at said meeting.

(D) The right to receive and the obligation to pay such fair cash value shall terminate if:

(1) Said shareholder fails to comply with the requests of the corporation to deliver his certificates for indorsement thereon of the aforesaid legend within the fifteen-day period above mentioned, or otherwise fails to comply with the provisions of this section, unless the corporation by its directors waives such failure;

(2) The corporation abandons, or is finally enjoined or prevented from carrying out, its purpose to effect such amendment or to carry out such transaction;

(3) The shareholders rescind the adoption of such amendment or authorization of such transaction;

(4) The shareholder withdraws his demand with the consent of the corporation by its directors.

(E) From the making of said demand until either the termination of the right arising therefrom or the purchase of the shares by the corporation, all rights accruing from such shares, including voting and dividend rights, shall be suspended except only the right of the holder to receive the fair cash value thereof. If during such suspension any

dividend is paid in money upon shares of such class, an amount equal to the dividend which, except for said suspension, would be payable upon said shares shall be paid to the holder of record thereof but as a credit upon the fair cash value of said shares. If the right to receive such fair cash value is terminated otherwise than by the purchase of the shares by the corporation, all rights of the holder thereof shall be restored and all distributions which, except for said suspension, would have been made thereon shall be promptly made to the holder of record of said shares at the time of said termination."

APPENDIX B

Opinion of 6th Circuit Court of Appeals,

Filed October 29, 1968.

(Caption omitted)

Before: WEICK, Chief Judge, EDWARDS and COMBS, Circuit Judges.

WEICK, Chief Judge. The controversy here grew out of the merger of Certified Mortgage Corporation (Mortgage) into Certified Credit Corporation (Credit).

The principal issue in the case is whether the merger of the two Ohio corporations involved a sale of securities within the meaning of Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 adopted by the Securities and Exchange Commission.[1] The District Judge held

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[1] Section 10(b), 15 U.S.C.A. Section 78(j) provides:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —

* * *

"(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10b-5, adopted by the Commission (17 C.F.R. §240.10b-5), provides:

"It shall be unlawful for any person, directly or indirectly by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange

"(a) to employ any device, scheme or artifice to defraud,

"(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(c) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person,

"in connection with the purchase or sale of any security."

that it did not and further that the action could not be maintained for the benefit of the shareholders as a class. He granted defendants' motion to dismiss and for a summary judgment. We reverse.

Plaintiffs owned Class A and Class B shares of Mortgage which they exchanged for shares in Credit pursuant to the plan of the merger. They instituted a suit in the District Court in behalf of themselves and all persons similarly situated, against the officers and directors in control of Mortgage, to recover the value of their shares of stock alleged to have been destroyed by the merger which they claim was accomplished by misrepresentations and concealment of material facts in proxy statements mailed by Mortgage to its shareholders. The suit was brought under the antifraud provisions of Section 10(b) and Rule 10b-5.

In granting the motion to dismiss and for summary judgment, the District Judge relied principally upon an amicus curiae brief filed by the Securities and Exchange Commission in 1943 in the case of *National Supply Co. v. Leland Stanford Jr. Univ.*, 134 F.2d 689 (9th Cir. 1943), *cert. denied*, 320 U.S. 773 (1943), and the decision of the court that agreed with it without any comment. The thrust of the court's opinion in *National Supply Co.*, however, was on another ground, namely, estoppel.

But the Commission, since 1951, has changed its position and is now of the view that a statutory merger or consolidation involves a sale of securities within the meaning of the antifraud provisions of the Act.

The Appellate Courts which have considered the question since have agreed with the present position of the Commission. *Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2nd Cir. 1967), *cert. denied*, 389 U.S. 970 (short form merger); *Dasho v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir. 1967), *cert. denied*, 389 U.S. 977 (statutory merger). To the same

effect is *Simon v. New Haven Board & Carton Co.*, 250 F.Supp. 297 (D.C.Conn. 1966) (statutory merger); *Voege v. American Sumatra Tobacco Corp.*, 241 F.Supp. 369 (D.Del. 1965) (short form merger); *H. L. Green Co. v. Childree*, 185 F.Supp. 95 (S.D.N.Y. 1960) (statutory merger).

The Act (15 U.S.C. 78c(a) (13) and (14)) defines 'purchase' as including ". . . any contract to buy, purchase, or otherwise acquire," and 'sale' as including ". . . any contract to sell or otherwise dispose of."

In construing these definitions, Judge Schnackenberg, in *Dasho*, said:

> "This broad language indicates an intention by Congress that the words 'purchase' and 'sale' are not limited to transactions ordinarily governed by the commercial law of sales. The purpose is evidently to make control of securities transactions reasonably complete and effective to accomplish the purposes of the legislation.
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> ". . . [I]n the case at bar, when the merger was approved and the exchange of securities occurred, the owner of stock had in effect purchased a new security and paid for it by turning in his old one. In such a situation the antifraud protections afforded by the Securities Act are needed no less than in a situation where one makes an outright purchase of stock for cash. We agree with counsel for the amicus curiae that the complex nature of a merger enhances the opportunities for fraud and thus increases the need for antifraud protection."

This broad reading of the word "sale" finds support in *S.E.C. v. W. J. Howey Co.*, 328 U.S. 293, 299 (1946) where the Supreme Court in interpreting the term "investment contract" stated that it would be construed according to

> ". . . a flexible rather than a static principle, one that is capable of adaptation to meet the countless and

> variable schemes devised by those who seek the use of the money of others on the promise of profits."

In *S.E.C. v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963), the court said:

> "A fundamental purpose [of the 1934 act] was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus achieve a high standard of business ethics in the securities industry."

The court further said that securities legislation aimed at avoiding fraud is to be construed

> ". . . not technically and restrictively but flexibly to effectuate its remedial purposes."

See also *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195 (5th Cir. 1960).

Ohio law required the merger to be approved by the directors of each corporation and by two-thirds of the shareholders. Dissenting shareholders are to be paid the fair cash value of their shares. Ohio Rev. Code §§ 1701.78, -.79, -.85.

The issuance by a corporation of its own stock has been held to make it a seller within the meaning of the anti-fraud provisions of the Act. *Ruckle v. Roto American Corp.*, 339 F.2d 24 (2d Cir. 1964); *Hooper v. Mountain States Sec. Corp., supra; Weitzen v. Kearns*, 271 F.Supp. 616 (S.D.N.Y. 1967); *Globus, Inc. v. Jaroff*, 266 F.Supp. 524 (S.D.N.Y. 1967).

A serious gap in the law would exist if millions of shareholders involved in the many mergers or consolidations which are effected today, were left unprotected by the anti-fraud provisions of the Act. The legislative history does not require such a construction to be given of the Act, and we do not so construe its language.

We conclude that the exchange of stock in the merger constituted a sale within the meaning of the Act.

Stock Subscriptions

The subscribers to stock in Mortgage who continued to make payments to Credit on their subscriptions after the merger, should be considered as stockholders entitled to the protection of the Act. Their holdings in Mortgage were involuntarily converted into shares of Credit by the merger. They should be entitled to the same protection as is afforded to shareholders involved in a short form merger. *Vine v. Beneficial Fin. Co., supra. Cf. S.E.C. v. Associated Gas & Elec. Co.*, 24 F.Supp. 899 (D.C.N.Y. 1938), *aff'd* 99 F.2d 795 (2d Cir. 1938); *S.E.C. v. North Amer. Fin. Co.*, 214 F.Supp. 197 (D.Ariz. 1959).

Class Suit

The District Judge originally ordered the case to proceed as a class suit, but in his order of dismissal he indicated that if the case had proceeded to trial he would have vacated that ruling. He was of the opinion that the persons comprising the class were so numerous as not to have had sufficient notice of the action, and further there was a probability that he would have held that each plaintiff must rely upon the alleged misrepresentations before there could be any recovery.

Appellants' brief indicates that there were about twelve hundred shareholders who were involved in an intrastate offering of the shares and they were all residents of Ohio. Their names and addresses are in the possession of counsel for plaintiff. There should be no difficulty in giving adequate notice if and when the District Court determines that notice should be given.

Class actions are governed by Rule 23, Fed.R.Civ.P. In our judgment, the allegations of the complaint are sufficient to bring the case within the provisions of Rules 23(A) and 23(B) (3).

This is not a case where some shareholders were treated differently. Proxy statements alleged to contain misrepresentations and material omissions were mailed to all shareholders. Questions of fact and law are therefore common to all of them. Using the language of the court in *Vine, supra,* it is a classic example of deception of an entire class, *id.* at 635.

Appellees contend that not all of the shareholders may have relied on the misrepresentations. They suggest that some may have signed proxies without reading the proxy statements, while others may not even have signed them.

It seems to us that this is defensive matter hardly relevant to a motion to dismiss which admits the allegations of the complaint well pleaded. *Vine, supra.*

As well stated in *Harris v. Palm Springs Alpine Estates, Inc.,* 329 F.2d 909, 914 (9th Cir. 1964):

> "Appellees assert that the various investors made payments on the securities at different times and stand in different positions with respect to the representations made to them and the reasonableness of their reliance, and therefore that questions of fact and law will arise which cannot be common to them all. Again, the argument is based upon factual premises which must be established in the trial court, not here. But even assuming these premises to be true, since the complaint alleges a common course of conduct over the entire period, directed against all investors, generally relied upon, and violating common statutory provisions, it sufficiently appears that the questions common to all investors will be relatively substantial. Rule 23(a) (3) 'does not require that all the members of the class be identically situated, if there are substantial questions

> either of law or fact common to all.' 3 Moore's Federal Practice ¶ 23.10 at 3454 (2d ed. 1963)."

To the same effect: *Fischer v. Kletz*, 41 F.R.D. 377 (S.D.N.Y. 1966); *Voege v. American Sumatra Tobacco Corp., supra.*

The complaint alleged that the defendants caused the merger to be effected by means of misleading, deceptive and manipulative devices and scheme in the particulars set forth therein. In *Vine*, which involved a short form merger, the court held reliance need not be shown where no volitional act is required. The court said at page 635:

> "Since the complaint alleges that plaintiff, in effect, has been forced to divest himself of his stock and this is what defendants conspired to do, reliance by plaintiff on the claimed deception need not be shown. What must be shown is that there was deception which misled Class A stockholders and that this was in fact the cause of plaintiff's claimed injury. The allegations of this complaint meet that test."

The District Judge relied on *List v. Fashion Park, Inc.*, 340 F.2d 457 (2d Cir. 1965), which held that the requirement that reliance be placed upon misrepresentation is carried over into civil suits under Rule 10b-5. The court was careful, however, to apply a different test to nondisclosure cases under Rule 10b-5. The court held that the following test should be applied in a nondisclosure case:

> "The proper test is whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact. Speed v. Transamerica Corp., 99 F.Supp. 808, 829; Kardon v. National Gypsum Co., 73 F.Supp. 798, 800 (E.D.Pa. 1947)."

List was not a class suit. It involved only one plaintiff.

In *Speed v. Transamerica Corp.*, 99 F.Supp. 808 (D.Del. 1951), *aff'd* 235 F.2d 369 (3rd Cir. 1956), recovery was allowed in shareholders' class suits involving nondisclosures. The case was tried on an amended complaint filed after the original complaint had been held insufficient, in *Speed v. Transamerica Corp.*, 5 F.R.D. 56.

In *Speed*, District Judge Leahy, referring to Rule 10b-5, said at page 828:

> "The rule is clear. It is unlawful for an insider, such as a majority stockholder, to purchase the stock of minority stockholders without disclosing material facts affecting the value of the stock, known to the majority stockholder by virtue of his inside position but not known to the selling minority stockholders, *which information would have affected the judgment of the sellers.* The duty of disclosure stems from the necessity of preventing a corporate insider from utilizing his position to take unfair advantage of the uninformed minority stockholders. It is an attempt to provide some degree of equalization of bargaining position in order that the minority may exercise an informed judgment in any such transaction. Some courts have called this a fiduciary duty while others state it is a duty imposed by the 'special circumstances'." (Italics ours)

In *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied* 390 U.S. 951 (1968), the court quoted from 3 Loss Securities Regulations, 1765 (2d ed., 1961) to the effect that in cases of nondisclosure, if reliance is a prerequisite to the rule, it is "little more than a formal requirement." The court approved the *List* test. *Myzel* involved four shareholders of a closed corporation who were induced by fraudulent representations and concealment to sell their shares.

In *Voege v. American Sumatra Tobacco Corp.*, *supra*, the court said that reliance could be inferred. It held (page 375):

"Finally, defendants say that plaintiff's action must be dismissed because there is no allegation that she relied on the manipulative or deceptive devices alleged, as List v. Fashion Park, 340 F.2d 457 (2nd Cir. 1965), is said to require. It may be fairly inferred, however, that when plaintiff purchased her shares she did rely upon the honesty and fair dealing of New Company and those who controlled it. Every contract contains the implied condition that the parties to it will act in good faith and deal fairly with each other in its performance. 17 Am. Jur.2d Contracts § 256, p. 653. Plaintiff necessarily relied upon this all-important condition when, by acquiring her shares, she agreed with Old Company and its stockholders that Old Company could be merged upon terms later to be determined."

In order to recover, plaintiffs must prove a violation of Rule 10b-5 and that they were damaged as a result thereof.

Some of the appellees contend that they were not directors or in control of Mortgage. These are issues of liability which were not passed upon by the District Judge and we decline to rule upon them. The liability of defendants will necessarily have to be determined at the trial where the plaintiffs will be required to support by evidence the allegations of their complaint.

Reversed and remanded.

Order of the United States District Court for the Southern District of Ohio, Filed April 24, 1967.

(Caption omitted)

ORDER

(Filed April 24, 1967)

This matter is before the Court upon motions of each defendant herein to dismiss and/or for summary judgment.

Quite briefly stated, plaintiffs have brought this action under Sections (10(b), 15 and 27 of the Securities Exchange

Act of 1934 and Rules of the Security and Exchange Commission promulgated thereunder. Plaintiffs allege that on and prior to December 21, 1959 they were holders of Class A and Class B common stock of Certified Mortgage Corporation; that on December 31, 1959, defendants in their capacity as directors of Certified Mortgage Corporation merged that Company with Certified Credit Corporation and that merger destroyed the Certified Mortgage Corporation stock and the investment of Certified Mortgage Corporation stockholders. Plaintiffs allege that defendants accomplished the merger by obtaining the consent and approval of plaintiffs and other stockholders through misrepresentations and concealment of certain facts which affected the desirability of said merger. It is alleged that proxy statements mailed to all stockholders were false, fraudulent, manipulative and deceptive. The defendants have urged various arguments in support of their respective motions but the Court deems it necessary to consider only one of those arguments, i.e., that the merger between Certified Mortgage Corporation and Certified Credit Corporation did not constitute a "sale" under the Securities Exchange Act of 1934 and the Rules promulgated thereunder and therefore the action cannot be maintained.

It is clear that plaintiffs' remedy does not lie under Section 15 or Section 27 of the Act as the former is concerned with jurisdiction and venue and the latter pertains to dealers and brokers engaged in selling over-the-counter in interstate commerce. It is Section 10(b) under which plaintiffs seek their remedy. Section 10(b), 15 U.S.C.A. Section 78 (j), provides:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —
> • • •

> "(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

And Rule 10b-5, adopted by the Commission (17 C.F.R. § 240. 10b-5), provides:

> "It shall be unlawful for any person, directly or indirectly by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange.
> "(a) to employ any device, scheme or artifice to defraud,
> "(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> "(c) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person,
> "in connection with the purchase or *sale* of any security." (Emphasis added).

The key word in the foregoing, for purposes of the present consideration, is the word "sale." This Court must determine whether the merger of December 31, 1959 between Certified Mortgage Corporation and Certified Credit Corporation constituted a "sale" or an exchange amounting to a sale. If the merger cannot be considered as either of the foregoing, then plaintiffs cannot rely upon Section 10(b) or Rule 10b-5.

In *National Supply Company v. Leland Stanford Junior University*, 134 F. 2d 689 (C. A. 9 1943), cert. denied, 320 U. S. 773 (1943) the plaintiff University filed an action

under §§12(1) and 12(2) of the Securities Act of 1933[1] to recover the value of certain National Supply preferred shares held by the University prior to National Supply's consolidation with a ninety-nine percent owned subsidiary. Plaintiff alleged that literature sent out was misleading in certain respects, that the plan of consolidation was unfair and constituted a constructive fraud and that the aforementioned Act had been violated. The Court of Appeals reversed a judgment for plaintiff and held that the consolidation of a Delaware Corporation with another corporation did not involve a "sale" of securities or an "exchange amounting to a sale" within the Securities Act of 1933 so as to render the civil liability provisions of the Act applicable in favor of dissenting stockholders. The Court stated, at page 694:

> "It is not clear to what extent the trial court was influenced by appellee's contention that the Securities Act of 1933 had been violated. Certain of the findings seem to indicate the belief that appellee has causes of action under both § 12(1) and § 12(2) of the Act. The Securities and Exchange Commission has filed an exhaustive brief amicus curiae indicative of its view that the consolidation did not involve a 'sale' of securities, or an exchange amounting to a sale, hence the civil liability provisions of the Act have no application. Without going into the matter, we may say that we are in accord with the view of the Commission."

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[1] The Securities Act of 1933 was intended to regulate the initial distribution of securities. Sections 12(1) and (2) of that Act provide for civil liability in connection with material misrepresentations and omissions in prospectuses and communications. Although the National Supply case was brought under the Act of 1933 and the instant case is brought under the Act of 1934, which was intended to regulate post-distribution trading of securities, the decision and its reference to what constitutes a "sale" are persuasive.

The brief amicus curiae referred to above by the Court of Appeals, discusses the so-called "no sale" theory. The following language from the brief is instructive:

> "*** [Referring to consolidations such as the one in the National Supply Company case and mergers under related sections of the law.] In such consolidations and mergers the alterations of stockholder's security occurs not because he consents to an exchange, but because the corporation by authorized corporate action converts his security from one form to another. That is to say (as indicated by the Note to Rule 5), there is no sale where (1) vote of the stockholders is effective (subject to directors' action and other statutory requirements) as corporate action and (2) this binds all stockholders, assenters, dissenters, and non-voters alike (subject only to appraisal rights of dissenters). The essence of the Commission's construction, as expressed in the Note, is that in such cases a proposed corporate act is submitted to stockholders to be accepted or rejected by them as a class in their capacity as members of the corporate body. Even though the stockholder may participate in the vote which results in changing his rights as a stockholder, his action in so doing is the action of a member of the corporation exercising his franchise, rather than the action of a securityholder choosing to accept an offer of exchange made to him as an individual; and obversely, the solicitation of his vote is nothing more than a request for exercise of his franchise as a member of the corporation, not an offer of exchange or sale of new securities to him as an individual. He is functioning precisely as he would be if he were voting on a charter amendment which would, for example, change the corporate purposes. The fact that his rights will be changed if the consolidation or merger is effected is a mere incident of the corporate action in which he is participating." At pages 9 and 10 of the amicus brief.

The brief further states:

> "The fact that the change occurs by action of the legal entity—the corporation—not by consent, emphasizes

the fact that the type of transaction under consideration lacks prime elements of every contract, and hence, of any "sale" as defined in the Act—offer and acceptance. The contractual definition relates to "every contract of sale or disposition of * * * a security * * * for value," and also 'every * * * attempt or offer to dispose of * * * a security * * * for value.' Manifestly this definition presupposes a contractual agreement to buy and sell a security, or an offer of sale looking to such a contractual agreement. In other words, a security cannot be "sold" under the terminology of the Act without an opportunity to the purchaser to exercise his volition on an individual basis. The construction adopted in the Note is supported, therefore, by the lack of any volitional action on the part of the stockholders other than their action in exercising their franchise as members of the corporate organization, which is not volition in contractual sense. As applied to statutory consolidations or mergers, the new securities to be issued are not "sold" to the stockholders, because the requisite vote of stockholders binds all stockholders whether or not as individuals they elect to accept or reject them.

"The corporate obligation to buy in the stock of dissenters is not inconsistent with the "no sale theory" of the Note to Rule 5. Stockholders have no power to choose to retain their existing status. The right of appraisal and payment is merely an opportunity provided by law for individual stockholders to sell out their interests in the corporation in the event that they disapprove of its corporate action. The existence of such a right does not give rise to any "sale" of a new security; for stockholders, if they remain in the corporation after the corporate action has been taken, have no power to retain their old securities in preference to the new. Their only alternative is seasonably to refuse to remain in the corporation and to secure the appraised value of their securities.

"We submit, therefore, that, when stockholders receive a proposal for corporate action by which their stock may be converted into other securities, no "sale" of these securities to them is involved." At pages 12 and

13 of the amicus brief. [The Note, to Rule 5 referred to above is the Commission's Note, Sec. Act Rel. 493(c) (1935) 3.]

And see I *LOSS, SECURITY REGULATIONS* (2 ed. 1961) wherein the author, at pages 521-522, states the following with respect to the "no sale" theory;

> "The theory is based on the proposition that in the described situations the alteration of the stockholder's security occurs not because he consents individually to an exchange but because the corporation by authorized corporate action converts his security from one form to another. In other words, certain types of corporate action require only a vote of directors; other types require a vote of stockholders; and, when a stockholder votes on a proposed merger of the like, he is simply acting as a member of one of the corporate organs to effectuate corporate action and not exercising his volition the way he would if each stockholder were individually offered a new security in exchange for his old. Accordingly, although the note to the old form mentioned only mergers, consolidations and transfers of assets, and did not refer to reclassifications of the securities of a single corporation, the same approach was always followed with respect to reclassifications (or split-ups) effected by the same type of vote."

See also *Ferraiola v. Newman*, 259 F. 2d 342 (C. A. 6 1958) wherein the Court discusses the meaning of "purchaser" under 16(b) of the Securities Exchange Act of 1934, 15 U. S. C. A. §78p(b), which provides that any profit realized by a corporate director resulting from his purchase or sale of the corporation's stock within less than six months shall inure to the corporation. Similarly, see *Roberts v. Eaton*, 212 F. 2d 82 (C. A. 2 1954).

The Court notes that the fact that after the merger Certified Credit Corporation collected money from people

who had subscribed for Certified Mortgage Company stock and then issued Certified Credit Corporation stock does not transform the merger into a sale. The subscriptions antidated the merger; therefore, no "investment decision" was required with respect to these subscriptions.

And it is clear that plaintiffs cannot seek relief under §10(b) for any alleged fraudulent mismanagement of corporate affairs. In *Birnbaum v. Newport Steel Corporation*, 193 F. 2d 461 (C. A. 2 1952), cert. denied 343 U. S. 956 (1952), plaintiff stockholders brought an action on behalf of themselves and others similarly situated and the corporation against Defendants alleging violation of Section 10(b) and Rule 10 b 5 in that the directors misrepresented facts concerning a proposed merger for the purpose of having the merger rejected by the stockholders thereby enabling a person who was a director, officer and owner of approximately forty percent of the outstanding stock of the corporation to sell his stock to a third party at a premium. The District Court dismissed the complaint; the Court of Appeals affirmed and stated, at page 464:

> "***When Congress intended to protect the stockholders of a corporation against a breach of fiduciary duty by corporate insiders, it left no doubt as to its meaning. Thus Section 16(b) of the Act of 1934, 15 U. S. C. A. §78p(b), expressly gave the corporate issuer or its stockholders a right of action against corporate insiders using their position to profit in the sale or exchange of corporate securities. The absence of a similar provision in Section 10 (b) strengthens the conclusion that that section was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs, and that Rule X-10B-5 extended protection only to the defrauded purchaser or seller. Since the complaint failed to allege that any of the

plaintiffs fell within either class, the judgment of the district court was correct and is accordingly affirmed."

See also *O'Neill v. Maytag*, 339 F. 2d 764 (C. A. 2 1964).

Finally, it should be noted that had this action proceeded to trial, the Court would have vacated its ruling wherein the action was ordered to proceed as a class action. See order dated September 6, 1966. The Court is of the opinion that the persons comprising the class are so numerous that they would not have sufficient notice of this action (Rule 23 (a), Federal Rules of Civil Procedure and compare *Kronenberg v. Hotel Governor Clinton, Inc.*, 10 F. R. Serv. 2d 23b. 3, case 1 (D. C. S. D. N. Y. 1966) and further, there is a probability that this Court would have held that each plaintiff must have relied upon the alleged misrepresentations before there could be any recovery. *List v. Fashion Park, Inc.*, 340 F. 2d 457 (C. A. 2 1965) and cases cited therein. If this case is appealed, counsel should fully brief the matters of class action and reliance before the Court of Appeals as those matters would have a material effect upon future proceedings if a trial of this case should be required.

In view of the foregoing, the motions of each defendant to dismiss and/or for summary judgment are hereby SUSTAINED and plaintiffs' complaint is hereby DISMISSED.

CARL A. WEINMAN
CHIEF JUDGE, U. S. DISTRICT COURT